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DEPT FOR WHA/BSC MDASHBACH, BFRIEDMAN, MDRUCKER, WHA/FO CMCMULLEN

E.O. 12958: N/A
TAGS: ECON PREL PGOV PA

SUBJECT: PARAGUAY'S 2008 ECONOMIC PERFORMANCE AND 2009 OUTLOOK

SUMMARY

¶1. (SBU) COMMENT: Following a period of strong economic growth in the first semester of 2008, economic activity decelerated during the last quarter of 2008 across the three main sectors of the economy: agriculture, services and manufacturing. GDP growth for 2009 is expected to slow down to 2 to 3 percent due to deteriorating international market conditions, insufficient rain, and a decline in commodities prices. Paraguay will need to implement policies to maintain economic stability, tackle poverty and promote growth -- measures outlined in the country's 2009 Contingency Plan that is now pending congressional approval. President Lugo's administration is looking for broad support to avoid congressional stonewall. Without expedited congressional approval of the contingency plan, piece-meal implementation of the GOP's plan will be too little, too late. END COMMENT.

ALMOST AN EXCELLENT 2008...

¶2. (U) According to the Central Bank, Paraguay experienced 5.8 percent growth in 2008 for a total GDP of 15.4 billion USD, registering its second best growth rate over the last six years. GDP per capita also increased 3.9 percent to 1,556 dollars, the highest level registered in the last 47 years. Agricultural production, the largest sector in the economy, contributed 20.2 percent. The agricultural bonanza benefited from benign weather and high commodity prices during the first half of 2008. Increased domestic demand driven by remittances and a relatively stable macroeconomic and political environment also contributed to Paraguay's growth. Remittances reached 680 million dollars in 2008. In the last quarter of 2008, however, international and domestic conditions for the agriculture sector rapidly deteriorated -- the financial crisis limited the offer of working capital; agricultural areas faced severe droughts; and increasing social unrest in rural areas disrupted production.

¶3. (U) Mechanized agricultural production increased cultivated land area and yields per hectare. The 2008 soy harvest reached a record high of 6.8 million tons, a 14.7 percent increase over 2007. The production of other crops also increased: corn (14 percent), sugarcane (18.3 percent) and rice (66.7 percent). Beef production increased 6.5 percent.

¶4. (U) Exports totaled 7.9 billion USD in 2008. (NOTE: The figure is the sum of registered (2.5 billion USD) and re-export (5.4 billion USD) exports. END NOTE). Major exports included soy and soy-related products (57 percent) and beef (14 percent). Paraguay's largest exports markets were Uruguay (17 percent) and Argentina (16

percent), and for beef Russia (41 percent) and Chile (35 percent). (NOTE: The EU included Paraguay on its Generalized System of Preferences Plus program in January 2009, which provides tariff exemptions on 6,400 different products. END NOTE.) Imports totaled 8.8 billion USD, with China (28 percent) and Brazil (27 percent) leading. As the dollar strengthened in the last half of 2008, the import of U.S. goods declined to 4 percent. Leading imports included capital goods (46 percent) and intermediate goods (29 percent).

¶5. (U) Considering that 2008 was a presidential elections year, Paraguay showed strong fiscal discipline, finishing the year with a budget surplus of nearly 0.15 percent of GDP. Fiscal performance was strong, with total revenue growth of 20 percent year-on-year and total spending expansion of 11 percent year-on-year.

¶6. (U) Paraguay's sixth and final review under the Stand-By Agreement with the IMF was positive. Over the last five years, real GDP rose by about 25 percent (more than in the previous 12 years), public finances remained in surplus throughout the period, public debt as a percent of GDP was reduced by more than half to less than 30 percent, and international reserves more than tripled to 2.5 billion USD in 2008. The country's long term sovereign debt risk rating, as reported by S&P, remained at the "B" credit rating. While offset by lower oil costs, rising food prices combined with a depreciated Guarani to push inflation to around 7.5 percent in 2008, up from 6 percent in 2007.

¶7. (U) Social conditions, however, did not improve. Increasing income inequalities, rising poverty, and growing unemployment accompanied Paraguay's growth. Most of the growth benefited the capital intensive agribusiness and encouraged urban flight. There was increased consumption from middle and high income sectors but the low and poor segments of the population suffered a reduction of purchasing power capacity as a result of inflation. Extreme poverty grew to 24 percent in 2007. During the year, social unrest in rural areas escalated, as landless peasants invaded properties owned by large producers.

...BUT INTO A CHALLENGING 2009

¶8. (U) Paraguay's 2009 outlook remains moderately positive, despite a challenging economic environment. The country's macroeconomic stability, relative isolation in the international capital markets, and reasonable capitalization of local banks (shielded almost entirely from the international financial crisis) will help Paraguay weather the current global financial turmoil. The GDP growth rate for 2009 is estimated at 2 to 3 percent, and inflation is projected at 5 to 6 percent. The current account surplus is expected to turn into a deficit in 2009, and the external debt of 3.2 billion USD in 2008 is likely to increase in 2009. The abrupt end of a cycle of elevated economic growth will also make fiscal policy much more challenging in 2009.

¶9. (U) Setbacks in international commodity prices and declining demand for commodities create strain for Paraguay's commodity-export model. Agricultural production in 2009 is projected to decline due to insufficient rains during the last quarter of 2008. Ongoing social unrest in rural areas will likely negatively impact agriculture production. The 2009 soy harvest is estimated at 3.6 million tons (43 percent less than 2008), with 2.5 million hectares of cultivated land and a yield of 1.5 kilograms per hectare. Producers are preparing for losses after a record-high year for production and prices.

¶10. (U) Savings are expected to increase, and spending, exports and remittances are expected to decline. A decrease in remittances from Paraguayans living abroad (mainly in Spain, Argentina and the US) to an estimated 500 million dollars in 2009 will weigh on domestic private consumption. The 2009 GOP budget increased by 11 percent, with health (21 percent) and education (8 percent) representing the largest increases. Paraguay plans to seek additional funds from the IFIs to balance its budget, and to increase spending on education and health.

¶11. (U) The poor management and widely reported deficient provision

of services by state-owned enterprises will continue to drag the economy down. The Supervisory Council of Public Enterprises, created under the Stand-by Agreement with the IMF, provides quarterly audits and assessments of the accounts and performance of the state-owned enterprises, but further measures to increase transparency and accountability will be required. Capital investments, particularly in transport infrastructure, will likely increase through concession mechanisms.

¶12. (U) Paraguay has the potential to become an important player in the biofuels sector. The government has expressed great interest in biofuels, and already has in place legislation to promote biofuels production and consumption. The GOP's focus is on ethanol production for the local market and for export and on biodiesel production by small rural producers for the local market. The government already approved seven biodiesel plants which should begin operating in ¶2009. Total estimated biodiesel production for 2009 is 30 million liters. In addition, there are 10 ethanol plants which are expected to produce 120 million liters in 2009. Meat exports are expected to increase significantly in 2009 as lower prices drive higher export volumes. After the December 2008 FDA approval, Paraguay also has potential to establish its reputation as a world provider of Stevia. Finally, Paraguay has unexplored market opportunities with U.S. and EU GSP programs.

2009 CONTINGENCY PLANS

¶13. (U) Paraguay's contingency plan aims to create jobs and maintain a GDP growth rate of 2 to 3 percent in 2009. The plan concentrates on three areas: infrastructure, social services, and investment. Paraguay plans to have a local debt offering to partially cover the cost of the plan, estimated at over 2 billion USD.

¶14. (U) The plan's first phase, which begun in October 2008, was aimed at ensuring liquidity in the banking system and managing resources with bilateral and multilateral organisms. The second phase focuses on infrastructure priorities such as the construction and improvement of roads, highways, housing and waterworks, and the

expansion of the conditional-cash transfer mechanism for low income families (from 50,000 to 120,000 families). The third phase will seek to improve credit access for the productive sectors, especially the agricultural sector. The fourth phase aims to implement measures to increase public and private spending. Congress must approve phases two through four.

COMMENT

¶15. (SBU) Though Paraguay's economic performance in 2008 was decent, 2009 will be a challenging year. Expectations and political stakes are high. President Lugo's social justice objectives - poverty reduction and employment - will continue to dominate the 2009 economic policy environment. However, Paraguay will need to move forward quickly in implementing policies to maintain economic stability, tackle poverty and promote growth -- measures outlined in the GOP's 2009 Contingency Plan. With a plan in the works since October, the Lugo administration is off to a bit of a slow start in rolling out its plan to face the financial crisis. The GOP is looking for congressional support of its plan, but may hit another snag when its plan reaches Paraguay's divided Congress. Without expedited congressional approval, piece-meal implementation of the GOP's plan could be too little, too late. END COMMENT.